Commission expresses concern that current affiliate transaction rules may motivate carriers to imprudently purchase or sell inter-affiliate services at amounts not reflective of value or arm's length principles.[56] In this regard, the Commission seeks comment on how the elimination of a sharing obligation in the price cap rules would impact this concern.[57] Further, the Commission tentatively concludes that it should not specify the methodologies that carriers must follow to estimate fair market value, and that carriers should make good faith determinations of the fair market value.[58]

NYNEX strongly opposes the use of the purported "fair market value" methodology proposed by the FCC for services. For the reasons stated herein, such application would be exceedingly costly, burdensome, difficult to verify, highly subjective and against the public interest.

At the outset, the Commission does not specify its "experience" that may warrant drastic changes to the affiliate transaction rules. In fact, developments subsequent to adoption of the joint cost rules cut against the Commission's point. As discussed, price cap regulation has strengthened carriers' incentives to cut costs and has thereby lessened any need for additions to the affiliate transaction rules.

Although NYNEX thinks that the present valuation method for asset transfers is unbalanced, we are not seeking to change that rule here. For NYNEX, such transactions are relatively infrequent and the fair market value of assets can generally be obtained through formal

---

[56] See NPRM ¶ 77.

[57] See NPRM ¶ 78.

[58] See NPRM ¶ 83.

or informal appraisals. Fair market value for services, however, presents an extremely difficult problem and one where the costs far outweigh the benefits as explained infra.

The Commission's long-standing distinction between assets and services for recording affiliate transactions[59] has a very sound basis that still applies. First, many services are most efficiently provided on a centralized basis. This allows for consistency among organizational units and for custom-tailored application that meets the specific need of the overall organization. Thus, affiliates are specifically set up to provide these centralized services. By imposing such burdensome valuation rules for affiliate services, the Commission would discourage such efficiency gains that could be passed on to the ratepayers.

Second, the fair market value of services cannot be readily ascertained, nor can it be ascertained with any degree of certainty. Fair market value is generally not a specific amount, but a range of amounts to differentiate quality, packaging of additional value-added services as part of the same service, and other such factors. For example, to take a non-complex service such as cleaning, there may be one rate for "light" cleaning and one for "heavy" cleaning but there may also be a wide range of rates for "heavy" cleaning based on such factors as the range of items to be cleaned, the guarantee, the level of insurance (bonding, no bond), etc. The valuation calculus becomes even more complex. In contrast to the variable and sometimes inchoate nature of services, assets are tangible items that can usually be valued via appraisals, surveys and other reasonable methods, although even there intangibles play a significant function in valuation.[60]

---

59 See Joint Cost Order ¶¶ 294-96; Joint Cost Reconsideration Order ¶ 91.

60 See Joint Cost Order, n. 469.

Notably, the definition of "fair market value" in Black's Law Dictionary speaks of "property" and "assets."[61]

Moreover, the Commission has previously rejected applying a fair market valuation requirement to affiliate services:

> Several parties have argued that if a tariff or prevailing price is unavailable as a measure of value, we should look to the value of similar services in the marketplace. We believe that such a valuation standard is fraught with the potential for abuse, and would be difficult to monitor. In contrast, by requiring carriers and their affiliates to allocate costs pursuant to the cost allocation standards, we can ensure that an auditable measure of the cost of the service is available.[62]

The Commission's observations that fair market valuation for services is difficult to monitor and that cost allocation standards provide an auditable measure, are still valid today. The Commission provides no basis in the NPRM for altering this view and thus for altering the current approach. In fact, our experience in seeking valuations in the asset area reinforces the Commission's earlier opinion.

Applying the proposed valuation methods to services would create unnecessary, costly burdens for NYNEX to determine what to book as "costs" for services provided by affiliates. The Commission has become very well acquainted with this plethora of functions and services in the audit process. The requirement that an artificial value be estimated or determined for these services would impose a cumbersome burden with no clear benefit to the ratepayers. Its only purpose would be to provide the Commission staff with what it perceives as a better monitoring device (which in fact is not better because it is imprecise and not determinable with any degree of

---

[61] Black's Law Dictionary, Henry Campbell Black, Fifth Edition, 1979.

[62] Joint Cost Reconsideration Order ¶ 131.

certainty in most instances). Such burden would increase dramatically the costs of providing the services, which would more than offset any savings, thereby defeating the Commission's own purpose of increasing cost efficiency through centralization.[63] Further, market valuation is simply inapplicable to the vast majority of inter-affiliate services, such as corporate governance and ownership functions, that are not typically out-sourced. Therefore, the Commission should maintain its previous position as stated in the Joint Cost Reconsideration Order (¶ 131) and reject the adoption of this method for affiliate services.

The Commission's proposal would impose an unnecessary burden of estimating fair market value for all the services between carriers and their affiliates (absent a tariff rate or prevailing company price), the provision of which is for the benefit of the carriers. The vague standard offered in the NPRM for estimating fair market value would necessitate the LECs allocating resources solely for the purpose of determining a regulatory "price" to book for the numerous services provided for their benefit. Typically, an outside consultant would need to be engaged to study the functions involved. The consultant would group related functions that comprise more general service functions; study those functions to understand all their aspects; try to identify comparable offerings in the marketplace;[64] and try to appraise such offerings. It is estimated that such a process would cost an average of $35,000 to $45,000[65] in external costs

---

[63] See NPRM ¶¶ 7, 10; CC Docket No. 96-149, NYNEX Comments filed August 15, 1996.

[64] Absent any comparable offerings, the consultant might determine the "reproduction cost" of the affiliate service as a surrogate for fair market value. However, reproduction cost would likely exceed fully allocated cost, and thereby not justify the costs of the valuation exercise.

[65] This is based on experience with valuation of technology product transfers under the NYNEX Technology Products Compensation Policy.

above to evaluate each individual service function. More complicated services may require more time to analyze and compare and may cost more. The determination of fair market value for services would place a prohibitive cost burden on the provision of centralized services that clearly benefit the NYNEX Telephone Companies and their ratepayers.

But these are not the greatest costs. In connection with the Affiliate Transactions Notice, NYNEX has evaluated the cost of compliance with the proposed valuation rule through the bidding process as suggested by the Commission. In 1993, the NYNEX Telesector Resources Group expended approximately $20 million in securing bids and contracting for certain assets and services required by the NYNEX Telephone Companies. The preponderance of services performed in this connection is for products and simple services with readily available performance specifications and prices. The proposed effort, by contrast, would typically involve the evaluation of services with a much broader spectrum and complexity of requirements. Directly comparable feature/function/price comparisons are seldom readily available, if at all. This entails significant expenditures and resources and where vendors suspect there is not an intent to out-source, accurate bids are extremely difficult to obtain. Often vendors will just elect not to bid. Sometimes vendors may even request fees to perform this service. Also, it must be borne in mind that services performed by an outside resource increase other internal costs, e.g., insurance and coordination costs. Further, the proposal would increase manifold the effort that is currently performed at Telesector Resources Group.

The cost of this additional burden would more than offset any perceived benefit the Commission's proposal would have for the ratepayers. Even after the LECs have determined, in good faith, what the fair market value is for a specific service, the Commission's staff or auditors could disagree subsequently, requiring the LECs to further expend resources to defend their decisions. All this would defeat the LECs' and the Commission's common goal of achieving cost efficiency without any improvement in the accuracy of the determination of the booked amount. Under Part 32 and GAAP, operating expenses recorded on regulated books should have clear and precise accounting support, which will facilitate scrutiny by auditors and regulators.

Therefore, absent a tariff rate or prevailing company price (see infra), the Commission should continue to permit inter-affiliate services to be recorded at fully allocated cost as a practicable, verifiable and auditable method that offers a reasonable surrogate for fair market value.

-- **Prevailing Company Prices:**

With respect to prevailing company prices, under the Commission's present affiliate transaction rules, a non-tariffed asset or service is deemed to have a prevailing company price whenever the BOC or affiliate that provides the asset or service also provides substantial quantities of it to nonaffiliates. When such a price exists, the rules require the carrier to record the affiliate transaction at that price.[66] Citing concerns that affiliate transactions may be dissimilar to nonaffiliate transactions, and concerns regarding difficulty of defining what constitutes a prevailing company price, the Commission proposes to eliminate the use of prevailing company prices for transactions between the BOC and its affiliates engaged in manufacturing, interLATA telecommunications origination and interLATA information services referenced in Section 272(a)(2).[67]

---

66 See 47 C.F.R. Section 32.27; NPRM ¶¶ 80-82.

67 See NPRM ¶¶ 80-82.

NYNEX disagrees with this proposal. Under the Commission's current rules, "substantial" sales to nonaffiliates establish a prevailing company price. This rule is based on the sound theory that if third parties are willing to pay such price in arm's length transactions with a willing seller, then the price is a good indicator of value and is reasonable for recognition in affiliate transactions. Indeed, the fair market value of assets and services that carriers provide to nonregulated affiliates is unlikely to fall below the prices carriers charge nonaffiliates. Also, the fair market value of assets and services that nonregulated affiliates provide to carriers is unlikely to exceed the prices nonregulated affiliates charge nonaffiliates.[68]

The FCC virtually concedes that prevailing company price accurately reflects fair market value.[69] Yet, the FCC would eliminate its reliance on prevailing company pricing and, under its proposal, would rely on the vague standard of fair market value. This is not a logical, or consistent, approach.

The Commission suggests that because affiliates are under common control, they may be "captive customers" of each other, and conduct business differently from nonaffiliate transactions.[70] The Commission's analysis here is misplaced and unrelated to its purported purpose of finding a reasonably reliable measure of fair market value. The fact that the costs

---

[68] See also definition of "fair market price" and "fair market value" in Black's Law Dictionary, supra: "[t]he amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts ... in the open market .... Usually the fair market price will be the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition."

[69] See NPRM ¶ 80.

[70] See NPRM ¶ 80.

incurred in conducting business with affiliates may not be the same as costs incurred in conducting business with external customers, has no relevance in determining fair market value.

The use of prevailing company price when a substantial external market exists should be continued, e.g., in NYNEX the use of detariffed or non-tariffed cellular rates. The adoption of a clear definition would clarify the rule and also establish consistency in application by the LECs. The Commission should not adopt inflexible rules in this respect. For example, there is a valid basis for assuming that a percent of sales much less than 75% constitutes an accurate measure of "fair market value."

In any event, based on the current record, there is no basis to assume that if any arm's length third party buyer is willing to complete the transaction at a certain price, that price is not a "fair market value." Thus, that is a reasonable price at which to book the same transaction with an affiliate. The NPRM is internally inconsistent in recognizing what will establish a true fair market value. On the one hand, for purposes of determining the value of services, the NPRM contemplates merely a single bid as constituting an accurate determination of fair market value. On the other hand, the NPRM would discontinue use of actual sales to determine an accurate fair market value for goods and services provided both to the external market and to affiliates.

Therefore, the Commission's current rule on prevailing company price should be retained and clarified. The Commission's rule in this regard should only require that the third party transactions used to establish fair market value be truly arm's length and that the parallel affiliate transaction be equivalent to that which was conducted with the third party. In order to be reflective of this reality, any percentage adopted by the Commission should be significantly lower than 75%.

– **Other Issues Concerning Separated Operations**:

With respect to Sections 272(e)(3) and 272(e)(4), the Commission invites comment on whether it should adopt specific accounting procedures to address the difference, if any, between the rates charged by BOCs when they provide interLATA or intraLATA facilities or services on a separated basis, and the costs that would be appropriately allocated for the underlying facilities or services.[71] NYNEX does not believe there would be any such difference; therefore, no such additional accounting procedures need to be adopted.

The Commission seeks comment about the status of tariff-based valuation if incumbent LECs are not required to provide interconnection and collocation services and network elements pursuant to tariffs.[72] NYNEX believes that, whether or not the use of prevailing company prices is continued, the FCC's affiliate transactions rules should permit the use of the rates appearing in publicly filed agreements and statements for tariffed rates. Such rates reflect arm's length transactions and fair market value.

The Commission solicits comment on using the prescribed interstate rate of return (11.25%) as the return on investment component of fully allocated costs recorded for affiliate transactions.[73] NYNEX supports the use of 11.25%, as well as the option of using a different rate of return so that a carrier could meet its obligations to both federal and State regulators and reduce its record-keeping burden.

---

[71] See NPRM ¶ 79.

[72] See NPRM ¶ 86.

[73] NPRM ¶ 88.

With respect to joint marketing, if an affiliate may share marketing personnel with a BOC, the FCC proposes to apply its cost allocation and affiliate transactions rules (with any necessary modifications) to any joint marketing of interLATA and local exchange services. In response to the FCC's request for comment, NYNEX concurs with that proposal and does not believe any additional accounting safeguards will be necessary, as discussed.[74]

With regard to Section 272 and Section 274 audit requirements, the Commission proposes that the independent auditor consider and discuss, among other things: "whether examination of the books has revealed compliance or non-compliance with the affiliate transaction rules and any non-discrimination requirements in the Commission rules."[75] NYNEX believes that the scope of that audit inquiry should be limited to new requirements under the Act. This will avoid duplication of existing audit processes such as the CC Docket No. 86-111 annual independent attestation audit. As required by Section 64.904 of the FCC Rules, that attestation audit examines carrier compliance with FCC Part 64 and Part 32 cost allocation and affiliate transaction rules, FCC Docket 86-111 Orders and the carrier's Cost Allocation Manual. That audit process has worked effectively, and need not be duplicated.

With respect to NPRM ¶ 105, the application of FCC affiliate transaction rules would provide more than adequate accounting safeguards for the joint activities permitted under Section 274(c)(2). Also, the Commission need not distinguish, for Title II accounting purposes, between transactions involving a BOC and its separated affiliate and those involving a BOC and its electronic publishing joint venture.

---

74 See NPRM ¶ 91.

75 See NPRM ¶¶ 93, 106.

In NPRM ¶ 109, the Commission inquires as to the steps needed to implement the Section 274(b)(1) requirement that the separated affiliate or electronic publishing joint venture maintain separate books, records, and accounts and prepare separate financial statements. At most, the FCC should provide that those entities keep their own books, etc. based on generally accepted accounting principles.

*   *   *   *   *   *

Finally, with respect to NPRM ¶ 125, NYNEX thinks that the FCC's proposals related to Sections 260 and 271-276 of the Act, as discussed, are sufficient to implement Section 254(k)'s requirements that carriers not "use services that are not competitive to subsidize services that are subject to competition" and that the Commission, "with respect to interstate services," establish rules necessary to ensure that regulated universal services "bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

IV. THERE IS NO BASIS FOR EXPANDING THE TYPES OF COST REALLOCATIONS FROM REGULATED TO NONREGULATED ACTIVITIES SUBJECT TO EXOGENOUS TREATMENT

The NPRM (at ¶ 123 & n. 250) refers to Section 61.45(d)(1)(v) of the Commission's rules, which makes eligible for exogenous treatment under price cap regulation: "[t]he reallocation of investment from regulated to nonregulated activities pursuant to § 64.901...." The Commission invites comment on whether all such reallocations to nonregulated activities that may result from the offering of telemessaging service should trigger an adjustment to lower price cap indices.[76]

---

[76] NPRM, ¶ 123.

There is no basis for expanding the types of cost reallocations from regulated to nonregulated activities subject to exogenous treatment. The FCC has previously made clear that its Rule 61.45(d)(1)(v) on exogenous treatment of investment reallocations from regulated to nonregulated, is narrow in scope. That rule only applies to the situation where, pursuant to Rule 64.901(b)(4),[77] joint network plant is allocated using the forward-looking peak nonregulated usage allocator; actual nonregulated usage turns out to exceed the projected forward-looking peak usage; and the carrier makes the required reallocation of network investment from regulated to nonregulated.[78]

In reference to the NPRM (¶ 123), there is no basis for expanding the types of cost reallocations from regulated to nonregulated to be given exogenous treatment, for three reasons. First, such action would probably result in a double-count under the price cap formula, which would harm LEC investors. In its X-Factor NPRM proceeding,[79] the Commission is considering adopting a moving average, Total Factor Productivity-based X-Factor (productivity offset) which "would recognize almost all of the costs for which exogenous treatment would now be accorded, leaving exogenous cost treatment requests only to cost changes which are truly unique to individual LECs."[80] The FCC's ongoing price cap performance review has been focused on the

---

77 See also Joint Cost Reconsideration Order ¶¶ 16-17, 28-41.

78 See LEC Price Cap Order, CC Docket No. 87-313, 5 FCC Rcd 6786, ¶¶ 171-72 (1990); Policy And Rules Concerning Rates For Dominant Carriers, CC Docket No. 87-313, 4 FCC Rcd 2873, ¶¶ 300-02 (1989); Annual 1991 Access Tariff Filings, Transmittal No. 452, 6 FCC Rcd 3792, ¶¶ 49-54 & n. 23 (1991)(Common Carrier Bureau rejected MCI broad argument for exogenous treatment of nonregulated cost shifts for investments or expenses).

79 CC Docket No. 94-1, released September 27, 1995.

80 See LEC Price Cap Performance Review Order ¶ 292; X-Factor NPRM ¶¶ 138-41.

X-Factor to ensure it continues to capture LEC productivity, including efficiency growth from new investment. As indicated earlier, the proposed X-Factor in the LEC price cap formula is designed to capture total company productivity growth, including nonregulated activities, provided on an integrated basis with regulated activities.[81] Under the Christensen Moving Average Total Factor Productivity ("TFP") methodology sponsored by USTA in the X-Factor NPRM proceeding, and supported by NYNEX, ongoing productivity enhancements and growth in such total company activities, including new investments, will be captured. Thus, for example, it would be duplicative to apply such an X-Factor plus make an exogenous cost adjustment for all cost reallocations from regulated to nonregulated.

Second, the Commission has changed its price cap rules on a going-forward basis to deny exogenous treatment of certain accounting rule changes which result in only a change in how books are kept and costs are recorded, not a change in economic cash flow.[82] Expansion of exogenous treatment of cost reallocations from regulated to nonregulated would appear inconsistent with that new rule, since Part 64 changes can be considered accounting rule changes,[83] and such changes would be noneconomic in nature and not impact carriers' discounted cash flow.

Third, additional downward exogenous changes with respect to cost reallocations would undercut LECs' incentive to engage in integrated nonregulated activities which would otherwise

---

[81] See Christensen Study, as cited in X-Factor NPRM at ¶¶ 22-25; Revised Christensen Study, appended to NYNEX Comments filed January 11, 1996 in response to X-Factor NPRM.

[82] See LEC Price Cap Performance Review Order ¶¶ 293-309; Bell Atlantic Telephone Companies v. FCC, 79 F.3d 1195, 1204 (D.C. Cir. 1996).

[83] See Joint Cost Order ¶ 90.

benefit the telephone ratepayer. The threat of artificial reallocations of such plant costs to nonregulated would hamper LEC pro-competitive efforts. In the case of new investments to be made, there should be no exogenous cost issue at all, since there are no existing costs to reallocate. In no event should LECs be penalized for new investments.[84] In addition, even if downward adjustments were made, and interstate access rates reduced, there is no assurance interexchange carriers would pass through such reductions to consumers.

[84] For example, downward exogenous adjustments would provide a financial disincentive to LECs building integrated broadband facilities that could otherwise create innovative competitive services for consumers. This would hurt consumer choice and thwart the most robust use of the network.

V. CONCLUSION

To realize the pro-competitive, deregulatory intent of the Telecommunications Act of 1996, the FCC to the extent possible should rely on its price cap regime and move away from applying unnecessary regulatory accounting rules. If the Commission continues to apply its Part 64 cost allocation and affiliate transaction accounting rules, NYNEX thinks those rules more than satisfy the Act's accounting requirements. Further restrictions are not warranted under the Act and would unduly hamper BOC's ability to realize economies of scale and scope that would benefit the telephone ratepayer.

Respectfully submitted,

The NYNEX Telephone Companies

By: Campbell L. Ayling
Campbell L. Ayling

1111 Westchester Avenue
White Plains, N.Y. 10604
(914) 644-6306

Their Attorney

Dated: August 26, 1996
ayling\96-150.doc